Supreme Court, U.S.
FILED
FEB 8 - 2011
OFFICE OF THE CLERK

Nº. 10-695

In The
Supreme Court of the United States

MARK D. LAY,
Petitioner,
v.
UNITED STATES OF AMERICA,
Respondent.

Petition For A Writ Of Certiorari To The United States Court of Appeals For The Sixth Circuit

REPLY BRIEF OF PETITIONER MARK D. LAY

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REPLY BRIEF OF PETITIONER MARK D. LAY

The Opposition of the United States is gravely flawed in the following numerous respects, evincing a need for further review of the Court of Appeals opinion affirming Petitioner's conviction:

1. Contrary to the Opposition claim,the Ohio Bureau of Workers Compensation (OBWC) did not pay Petitioner $2.million in fees for services related to the Active Duration Fund (ADF). As the express terms of the relevant Private Placement Memorandum (PPM) provide, all fees were paid by ADF, through the ADF Administrator, Olympia Capital.OBWC did not pay any fees to Petitioner for ADF.

2. Given the formula under which the fees of the ADF Investment Adviser, Petitioner, were calculated, it would have been impossible for OBWC to determine how much Petitioner was due in fees without knowing the net asset value of ADF. Accordingly, contrary to the Opposition argument, Petitioner could not have concealed and misrepresented the magnitude of leverage or losses, given that knowledge of these matters is an essential component to computing what amount of fees were owed.

3. Contrary to the Opposition argument, the opinion of the District of Columbia Court of Appeals in Goldstein indeed held that no hedge fund adviser could create a client relationship with a hedge fund investor and did not leave open the possibility that a narrower regulation than the proposed SEC Rule might be permissible under 15 U.S.C. §80b-3(b)(2).

4. Contrary to the Opposition argument, SEC Rule 13 merely criminalized certain hedge fund adviser conduct, it did not overrule Goldstein.

5. The Opposition merely parrots the unsupported statement in the Court of Appeals opinion that trade confirmation slips lulled OBWC into a sense of security. There was no evidence of any nature to support the requirement that these slips in some manner caused OBWC to part with money or property; and

6. The Court of Appeals failed to follow its own decision in United States v. Smith, 419 F. 3d 521 (6th Cir. 2005) concerning the limiting instructions that should have been given to the jury in connection with the reading of Petitioner's civil deposition testimony.

These weaknesses in the Opposition combine with the novel nature of the investor/client conflicting circuit court opinions to render the need for further appellate review here essential.

Accordingly, it is respectfully requested that certiorari be granted.

ARGUMENT

The Opposition of the United States underscores the need for further review of the Opinion of the Court of Appeals for the reason it fails to address the ongoing regulatory measures being taken by the Securities and Exchange Commission to clarify duties owed by investment advisers to private funds, such as the Active Duration Fund here.[1] The Opposition also would

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1 The SEC has now proposed rules to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding investment advisers to private funds, such as hedge funds and private equity funds...

Proposed Rule: Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3110 (November 19, 2010), available at http://sec.gov/rules/proposed/201/ia-3110.pdf (the "implementing release"); and Proposed Rule:

have this Court totally ignore all of the operative agreements that governed ADF, Petitioner's relationship to OBWC, and the limitation imposed by these agreements, including the restrictions of hedge fund investments to qualified or sophisticated investors.

The Opposition incorrectly states that Petitioner received compensation from the Ohio Bureau of Workers Compensation (OBWC) for services as the ADF Investment Adviser. The express terms of the governing agreements, i.e. the PPM and ADF investment adviser agreement refute this. Furthermore, there was no evidence whatsoever in the form of checks or transfers of any nature to establish that any fees paid to Petitioner were paid by OBWC, all fees having instead been paid, in accordance with the ADF Private Placement Memorandum by the Fund Administrator, Olympia Capital. The Opposition attempts to create an investment structure that is a

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Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers, Release No. IA-3111 (November 19, 2010), available at http://www.sec.gov/rules/proposed/2010/ia-3111.pdf (the "exemptions release"). (See, Sullivan & Cromwell, LLP, November 24, 2010 Newsletter)

attempts to create an investment structure that is a complete fiction. It ignores both the fundamental agreements governing ADF and its operation, and the motivation of an investor such as OBWC to invest in a hedge fund, which is the opportunity to realize more lucrative returns from exotic investments and riskier investments that are unavailable to the general investing public.

The inconsistent arguments advanced by the United States support the need for further review. There is no other case known to Petitioner where it has been determined that a hedge fund investor may also be a hedge fund client.

Under Goldstein it is clear that investment advisers do not owe fiduciary duties to hedge fund investors for the reason the investors are not the advisers' clients and as such observing fiduciary duties to the investor instead of the fund would pose inevitably conflicts of interests.

In point of fact, Goldstein states:

> [C]ongress did not intend "shareholders, limited partners, members, or beneficiaries" of a hedge fund to be counted as "clients." Although the statute does not define "client," it does define "investment

adviser" as "any person who, for compensation, engages in the business of advising others, either *directly* or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." *15 U.S.C. §80b-2(11)* [**19] (emphasis added). An investor in a private fund may benefit from the adviser's advice (or he may suffer from it) but he does not receive the advice *directly*. He invests a portion of his assets in the fund. The fund manager - the adviser - controls the disposition of the pool of capital in the [*880] fund. The adviser does not tell the *investor* how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor fades into the background; his role is completely passive. If the person or entity controlling the fund is not an "investment adviser" to each individual investor, then *a fortiori* each investor cannot be a "client" of that person or entity. These are just two sides of the same coin...

> If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the advisor will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to an investor in the fund, however, would likely include any and all measures to remain solvent. [**25] His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem them the shareholders in a corporation the "clients" of the corporation's lawyer or accountants. *See RESTATEMENT, supra §96 cmt. B* ("By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals...who have an ownership or other beneficial interest in it, such as its shareholders"). While the shareholders may benefit from the professionals' counsel indirectly, their individual interest easily can be drawn into conflict with the interest of the entity. It simply cannot be the case that investment advisers are the servants of two masters in this way.

Id. (Emphasis added.)

In light of the language it is erroneous to state Goldstein left the issue open.

In May of 2002, MDL founded the exempt ADF Hedge Fund in Bermuda. **Due to the nature of this investment vehicle and the rules and regulations related hereto, the ADF Hedge Fund was required to be established pursuant to a completely separate and distinct business relationship between MDL and the Bureau that was not connected to and in way dependent upon the pre-existing relationship with the Bureau**. (Emphasis added). The ADF Hedge Fund consisted primarily of government, corporate, and mortgage-backed securities.

The ADF Hedge Fund was intended to receive the investments of the Bureau and potentially other investors as well. (Testimony of T.C. Gasper, Doc. #102, p. 43). In bond markets, long term bonds generally decline in value in a rising interest rate environment. Thus a fund that allows an investor to maximize its short bond position is a natural "hedge" against rising interest rates. Short selling, or leveraging, increases the advantage of taking a short position in the bond market. The primary document governing the creation of the ADF Hedge Fund and the business

relationship the Bureau, Lay and MDL was the Private Placement Memorandum (hereinafter referred to as the "PPM."). In the PPM, the ADF Hedge Fund was part of an overlay strategy to assist in protecting the Bureau's overall portfolio of investments from the threat of rising interest rates: "The Fund will seek to capture significant gains during periods when interest rates are generally declining and will seek to protect principal during periods when rates are generally increasing." (PPM, p.iv).

It is common knowledge now and at the time this fund was created that a hedge fund is a high risk investment vehicle.

Several specific examples of this exist in the PPM. At the outset of the PPM, it is stated, in all capital letters:

> PROSPECTIVE SUBSCRIBERS IN THE FUND SHOULD INFORM THEMSELVES AS TO THE LEGAL REQUIREMENTS AND TAX CONSEQUENCES WITHIN THE COUNTRIES OF THEIR RESIDENCE AND DOMICILE FOR THE ACQUISITION, HOLDING OR DISPOSAL OF SHARES AND ANY FOREIGN EXCHANGE REGISTRATIONS WHICH MAY BE RELEVANT TO THEM. IF YOU ARE IN ANY

> CONSULT YOUR STOCKBROKER, SOLICITOR, ACCOUNTANT OR OTHER FINANCIAL ADVISER.

(PPM, p. ii).

(PPM, p. 23). (emphasis in the original).

Investors are further informed that, due to the nature of ADF Hedge Finds, they are not afforded the same protections as more conservative investment vehicles...

> THE PURCHASE OF SHARES IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. THERE IS NO ASSURANCE THAT THE FUND WILL BE PROFITABLE. SEE THE SECTION ENTITLED "RISK FACTORS" WITHIN THIS MEMORANDUM FOR A DESCRIPTION OF CERTAIN RISKS INVOLVED IN THE PURCHASE OF SHARES.

(PPM, p. iii) (Emphasis in the original).

The following excerpts from the PPM totally refute the Opposition claim that OBWC paid Petitioner's fees:

Investment Adviser Compensation

The Investment Adviser will receive a quarterly management fee determined at a rate equal to 1% per annum of the Fund's Net Asset Value, accrued monthly and payable in arrears as of the end of each calendar quarter. It also will receive a quarterly inventive fee (the "Incentive Fee") equal, in the aggregate, to 20% of the increase in Net Asset Value of each series of Shares over the sum of (i) the Series' Net Asset Value as of the commencement of each calendar quarter plus (ii) the yield on the Fund's portfolio at a rate equal to the yield of the Lehman Government Credit Index for such period (the "Hurdle"). A series of Shares will only be charged with an Incentive Fee if its Net Asset Value at the end of a quarter (prior to accrued Incentive Fees), if any, for the quarter is greater that (i) its Net Asset Value at the time of its initial subscription (or the Initial Closing Date, whichever is later) or (ii) its Net Asset Value at the time the last Incentive Fee was charged against such Series, whichever is higher, plus the Hurdle (the "High Water Mark"). In the event that the

Fund invests in the Master Fund, the Investment Adviser will not be entitled to a separate management or investment advisory fee as manager of the Master Fund but will be entitled to reimbursement for expenses incurred on behalf of the Master Fund...

Calculation of Investment Adviser Compensation

The Fund will pay a management fee to the Investment Adviser equal to 1% per annum of the Fund's Net Asset Value at the end of each calendar quarter. The management fee is accrued monthly in arrears and paid as of the end of each calendar quarter.

The Fund also will pay a quarterly Incentive Fee to the Investment Adviser equal to 20% of "Net Profit" with respect to each series of Shares. See "SERIES OF SHARES" below. "Net Profit" is defined as the excess of the Net Asset Value of a Series as of the end of the quarter (after deduction of the Management Fee accrued for the quarter but excluding any deduction for Incentive Fees accrued on each Series) less the sum of (i) the Net Asset

Value of the Series as of the first day of the quarter plus (ii) the amount of interest which would have been earned during the quarter if the Fund's net assets had been invested at a rate equal to the yield on the Lehman Government Credit Index for the quarter (the "Hurdle") adjusted to reflect subscription and redemptions with respect to such period.

Incentive Fees are based only on the portion of the appreciation in the Net Asset Value of a Series of Shares during a quarter that constitutes an increase in its Net Asset Value in excess of the sum of the cumulative Hurdle and its highest Net Asset Value as of the end of any prior quarter or, for the quarter the Series are redeemed at any time other than the end of a quarter, the date of redemption will be treated as such shares. The amount of any Incentive Fee accrued with respect to the redeemed Shares will be payable to the Investment Adviser, notwithstanding that following the redemption, the Net Asset Value of the relevant Series of Shares decreases...

This language in the PPM makes it clear the Petition's fees were paid by Olympia Capital as Administrator for ADF, not OBWC. It also makes clear that whoever paid the fees had to have intimate knowledge of ADF's performance. Accordingly, it is inconsistent to contend, as the Opposition does, that OBWC paid the fees but was misled concerning ADF status. In other words, it is illogical to contend that OBWC paid Petitioner's fees, but was not aware of factors such as the daily net asset value of ADF, a critical component of fee calculation.

OBWC was a sophisticated investor. Participation in ADF was limited to sophisticated investor.

In point of fact the PPM states:

> **Eligible Subscribers**
> The Shares are offered only to Qualified Holders. Qualified Holders are "non-United States Persons" and U.S. tax-exempt investors who are "qualified eligible participants" under CFTC Regulation 4.7 and "qualified purchasers" under Section 3(c)(7) of the Investment Company Act.

The dissent in this action determined that the government's explanation of the significance of mailing trade confirmation slips is amorphous at best. In Petitioner's case all trades were done correctly. The government alleged that the trade confirmations were used in a scheme to over leverage the Active Duration Hedge Fund (ADF). The evidence at trial however did not show how any of the trades accomplished over leveraging. The fact is many trades reduced leverage, and many trades were profitable. The evidence did not address individual trades or the dates of the trades. Without showing the daily position of the fund and any losses generated by the trades, the confirmation slips in and of themselves did not advance the government's case.

The trade confirmation statements did not contain false information. In cases where mailing trade confirmation statements constituted a violation of 18 U.S.C. §1341, the statements were transmitted for the purposes of executing the artifice of scheme. See, United States v. Marando, 504 F.2d 126(2d Cir. 1974) where trade confirmation slips were mailed and determined to be an integral part of a scheme to obtain property; also see,

United States v. Grossman, 843 F. 2d 78 (2d Cir. 1988) where it was determined that:

> The mailings of the confirmation slips did further the purpose of executing the scheme. The confirmation slips (1) notified the relatives that the purchase or sale actually had been completed; (2) provided an on-going tally of purchases, allowing the relatives to cover each other's positions; (3) concealed the fraud by maintaining an appearance of normality, see, United States v. Cohen, 518 F.2d 727, 737 (2 Cir), cert denied, 423 U.S. 926, 46 L. Ed. 2d 252 (1975): and (4) allowed the relatives to demonstrate ownership after the recapitalization announcement. Pereira v. United States, 346 U.S. 1, 98 L. Ed. 435, 74 S. Ct. 358 (1954). [**27].

To establish a violation of the mail fraud statute, "the mailing must be for the purposes of executing the scheme." United States v. Maze, 414 U.S. 395 (1974). To state an offense under 18 U.S.C. §1341 this Court determined in Cleveland v. United States, 531 U.S. 12 (2000) that the evidence must show that the defendant not only devised scheme or artifice, but also used that scheme or artifice to

obtain money or property. See, United States v. Males, 459 F. 3d 154 (2d Cir. 2006) (Emphasis added). Here the evidence showed ADF received its first $100,000,000.00 before Mr. Lay ever executed a trade. There was no evidence that the mail was used to obtain money or property. There was no evidence that property or money was obtained through a scheme that involved the use of the mail. The trade confirmation slips here unlike those in Grossman or Mirando did not contain false information, did not document illegal insider trades, and were not transmitted to obtain money or property. The alleged nondisclosures and misrepresentations concerning leverage alleged by the government were not related to the mailing of confirmation slips. The trades reflected on the listed slips were lawful trades for a hedge fund. It does not matter that OBWC did not authorize them, the relevant private placement memorandum gave ADF's board sole discretion to deviate from the fund's leverage guideline, not OBWC. The trade confirmation statements report the purchases of securities on a certain date, from a certain broker, at a certain price. All of that information was true, in every instance. On these

facts a violation of 18 U.S.C. §1341 was not established.

Here OBWC invested funds in ADF on three discrete dates, August 20, 2003, May 21, 2004 and September 23, 2004. These are the only times OBWC "parted" with property.

In Skilling the Court pointed out the requirement for symmetry in a standard mail fraud case, that is the victim's loss of money or property supplied the defendant's gain with one the mirror image of the other. Id. at *82. Here there was no gain to Petitioner.

The District Court stated in Petitioner's sentencing memorandum:

> Looking back in hindsight, as the Court can do, it seems obvious that he should have stopped following the investment strategy he had in place. But at the time, no one had ever seen an instance in which rising bond process would not lead to a devaluation of existing bonds. But that is precisely what happened in this time frame. It was the first time in economic history of the United States that that occurred, and his strategy

> failed and because of the leverage, failed dramatically.
>
> ***
>
> It seems apparent that the defendant had not lost any monies for any clients in the management of the MDL investments until the defendant began excessive over-leveraging with the ADF... It does not appear to the Court that the defendant was motivated to gain more income by his management of the ADF.

(Trial Court Doc. #181 p. 23) (emphasis added).

Aside from errors related to fees, status as a client, the lack of gain and fraudulent mailings, the District Court erroneously failed to issue a proper limiting instruction as required by United States v. Smith, 419 F.3d 521, 529 (6th Cir. 2005). Therein, the Sixth circuit stated that it is an abuse of discretion to fail to give a proper cautionary instruction "'to guard against the dangers of undue emphasis and context.'" Id. (quoting, United States v. Tines, 70 F.3d 891, 897 (6th Cir 1995). Smith emphasized the need to instruct as to both components, to prevent the undue influence on the jury regarding the testimony and to prevent taking the testimony out

of context of the circumstances of the original testimony. Id.

During the jury deliberations, the jury requested to see the transcript of Petitioner's prior testimony. Prior to allowing the jury's request, and over Petitioner's objections, Judge Dowd of the District Court stated that he was only giving half of the instruction required by the Smith case because he did not understand the second requirement to caution the jury to not take the testimony out of context. (Trial tr., Doc. #145, pp. 552-554, October 30, 2007). Failing to exclude or give a limiting instruction as to Petitioner's opinions as to legal conclusions regarding client and investor was prejudicial to Petitioner's defense, in and of itself. This prejudice was compounded by the district court's refusal to give the proper limiting instruction. The testimony was taken out or context by the jury. The jury was not told that Petitioner had testified in a civil case involving totally different issues.

CONCLUSION

By reason of the these errors, none of which the Opposition adequately addresses, further review should be accorded to Mr. Lay.

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